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Supreme Court of the United States

October Term, 1977
No. 77-1016

UNITED CALIFORNIA BANK and LILLIAN DISNEY TRUYENS, Co-Executors of the Estate of WALTER E. DISNEY,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

PETITIONERS' OPENING BRIEF.

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Opinions Below.

United California Bank v. United States (9th Cir. 1977), 563 F.2d 400, reversing *United California Bank v. U.S.* (C.D. Calif. 1974) 75-1 CCH U.S. Tax Cases ¶9164.

Jurisdiction.

The judgment of the United States Court of Appeals for the Ninth Circuit was entered on October 19, 1977, reversing the District Court's judgment dated December 9, 1974, in favor of the petitioners. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Question Presented.

Whether the Court of Appeals erred in requiring the petitioners to include, in the amount of long-term capital gains subject to the alternative tax under § 1201(b) of the Internal Revenue Code of 1954, the portion of such gains which was owned by a tax-exempt charitable organization and held by the petitioners in their capacity as co-executors of a decedent's estate.

Statutes Involved.

The following statutes are printed in an appendix at the end of this brief. (All appear in the versions which were in effect during the taxable years in question.)

Internal Revenue Code (26 U.S.C.) § 501(a) and (c)(3)
Internal Revenue Code (26 U.S.C.) § 642(c)
Internal Revenue Code (26 U.S.C.) § 643(a)
Internal Revenue Code (26 U.S.C.) § 661(a)
Internal Revenue Code (26 U.S.C.) § 662(a)
Internal Revenue Code (26 U.S.C.) § 691(c)
Internal Revenue Code (26 U.S.C.) § 1201(b)
Internal Revenue Code (26 U.S.C.) § 1202
California Probate Code, § 300
California Probate Code, § 1000

Statement of the Case.

Petitioners are the co-executors of the estate of Walter E. Disney, who died on December 16, 1966, a resident of the County of Los Angeles, California. By the terms of his will, Mr. Disney left 45% of the residue

of his estate to the Disney Foundation, as trustee for both the Disney Foundation and the California Institute of the Arts, both of which entities are charitable organizations, exempt from tax under Internal Revenue Code § 501(c)(3) [26 U.S.C. § 501(c)(3)].[1]

During each of the years 1967 and 1968, the petitioners, as co-executors of Mr. Disney's estate, sold certain securities which were included in the residue of Mr. Disney's estate and realized long-term capital gains on said sale. Pursuant to the terms of Mr. Disney's will, 45% of said long-term capital gains was permanently set aside for the Disney Foundation, as charitable trustee.

In their Fiduciary Income Tax Returns for the years 1967 and 1968, the petitioners computed the estate's income tax by applying the alternative tax on capital gains provided by Internal Revenue Code § 1201(b).[2] At all times relevant to this case, § 1201(b) prescribed, in effect, a maximum tax of 25% on long-term capital gains, this tax being characterized as an "alternative tax" in the sense that it is utilized as an alternative to the "normal" tax provided by § 1202.[3] Since

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[1]See Appendix of Statutes Involved. All statutory provisions set forth therein appear in the versions which were in effect during the taxable years in question.

[2]See Appendix of Statutes Involved.

[3]See Appendix of Statutes Involved. Under the statutory language, neither the "normal" tax resulting from § 1202 nor the "alternative tax" resulting from the utilization of § 1201(b) is, in fact, imposed on long-term capital gains as such. Rather, such taxes are imposed on the "excess" of "net long-term capital gain" over "net short-term capital loss". However, in a situation which involves neither short-term nor long-term capital losses, it is simpler and no less accurate, in lieu of referring to such "excess", to refer simply to "net long-term capital gain" or, even more simply, to "long-term capital gains."

§ 1202 permits the taxpayer to deduct from gross income an amount equal to 50% of long-term capital gains, application of § 1202 results in an effective tax on long-term capital gains at a rate equal to one-half of the marginal rate at which the taxpayer's income is taxed. Thus when the taxpayer's marginal rate exceeds 50%, the effective rate on long-term capital gains resulting under § 1202 will exceed 25% and the taxpayer will, as an alternative, utilize the 25% rate provided by § 1201(b).[4]

At all times relevant to this case, § 501(c)(3) of the Internal Revenue Code exempted from income tax charitable organizations such as the Disney Foundation, and § 642(c)[5] allowed to estates and trusts an unlimited deduction for amounts paid to, or set aside for, such charitable organizations. Under the relevant local law, Calif. Probate Code § 300,[6] the Disney Foundation, as designated beneficiary under Mr. Disney's will, held title to 45% of the residue of Mr. Disney's estate from the time of his death, subject

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[4]In a technical sense, § 1202 is utilized even when one applies § 1201(b), since the computation of the alternative tax begins with taxable income, and since the computation of taxable income includes the 50% long-term capital gains deduction which is provided by § 1202. However, the computation of the "partial tax" under § 1201(b)(1) modifies taxable income by subtracting therefrom the other 50% of the long-term capital gains, thereby resulting in an amount subject to the partial tax which is equal to the taxpayer's ordinary net income. Since the substance of this "partial tax" computation is thus the deduction, or exclusion, of all the taxpayer's long-term capital gains, in lieu of the deduction of 50% thereof under § 1202, and since the "partial tax" is then supplemented by the 25% tax on capital gains provided by § 1201(b)(2), the alternative tax is, in substance, an "alternative" to the 50% capital gains deduction provided by § 1202.

[5]See Appendix of Statutes Involved.

[6]See Appendix of Statutes Involved.

to the possession of the petitioners and the control of the probate court for purposes of estate administration.

Based upon the foregoing statutory provisions, and the policy underlying them, petitioners viewed themselves, with respect to 45% of the estate's residue, merely as conduits for the Disney Foundation, having possession of property of which a tax-exempt charitable organization was the owner and receiving as such conduits any capital gains which resulted from sales out of that charitable organization's 45% interest. Accordingly, in computing the alternative tax under § 1201(b) in this case, the petitioners did not include the Disney Foundation's 45% interest in the capital gains in the amount of capital gains subject to the alternative tax. Thus, no tax was paid on the said 45% and the remaining 55% of the capital gains received the benefit of the alternative tax. This is the same result which would have occurred had the petitioners distributed to the Disney Foundation 45% of the securities which were sold and had that charitable organization sold said 45% of the securities on its own behalf.

The respondent, however, disallowed the petitioners' exclusion of the said 45% from the amount to which the alternative tax was applicable, the respondent taking the position that, in the application of the alternative tax in the case of an estate or trust, said tax must be imposed not only on that portion of the gain passing to taxable beneficiaries but also on that portion of the gain which is owned by a tax-exempt charitable beneficiary. As a consequence of respondent's disallowance, the alternative tax was unavailable to the Disney estate, and the petitioners were required to

pay additional amounts of tax and interest.[7] The petitioners paid said additional amounts of tax and interest and filed timely refund claims therefor. Following the respondent's disallowance of said refund claims, the

[7]The additional tax resulting from the application of § 1202 in this case may be demonstrated by a simplified example, using hypothetical figures. Assuming ordinary taxable income of $20,000. capital gains of $500,000, and a governing instrument giving 50% of the estate to charity, the estate would compute the tax under § 1201(b) by computing the "partial tax", under § 1201(b)(1), on the ordinary income (computed as follows: partial tax, assuming 30% effective rate = $20,000 × 30% = $6,000) and then adding to the "partial tax" the 25% capital gains tax, under § 1201(b)(2), computed on that 50% portion of the capital gains which was not set aside to charity (capital gains tax = $500,000 × 50% × 25% = $62,500). Thus, the total tax as computed by the estate under § 1201(b) would be $68,500 ($6,000 + $62,500 = $68,500).

Assuming a 60% effective rate under § 1202, the tax under that section would be computed by subtracting from gross income both the 50% capital gains deduction under § 1202 and the charitable set aside deduction under § 642(c), and by then applying the 60% rate to the balance, as follows:

§ 1202 tax = 60% × ($20,000 + $500,000 — $250,000 — $125,000)

§ 1202 tax = 60% × $145,000

§ 1202 tax = $87,000

Since the tax computed under § 1202 would thus exceed the tax computed by the estate under § 1201(b), the estate would utilize § 1201(b) and pay the lower tax resulting under that section.

Under respondent's theory, however, the capital gains tax under § 1201(b)(2) would be computed on 100% of the capital gains, including that portion owned by and set aside to charity. Thus, respondent would compute the § 1201(b)(2) capital gains tax as follows: $500,000 × 100% × 25% = $125,000. Since this amount alone exceeds the tax computed under § 1202, the respondent's position would compel the estate to apply § 1202, even though the tax resulting under § 1202 exceeds the tax computed under the petitioners' application of § 1201(b).

Petitioners herein recognize that the application of § 1202 does, in effect, exempt from tax the amount set aside to charity, as the tax is computed under that section. However,

petitioners filed the complaint herein, and, after a trial upon stipulated facts, the District Court rendered judgment in favor of the petitioners. The respondent thereupon filed its appeal, and, following the hearing of said appeal, the Ninth Circuit Court of Appeals reversed the judgment of the District Court and entered judgment for the respondent.

Thereafter, the petitioners filed herein their Petition for Writ of Certiorari. Said Petition was granted by Order of this Court dated March 20, 1978.

Summary of Argument.

The question presented by this case arises from the conjunction, in a particular context, of two fundamental principles of the federal income tax law. These two principles are, first, that the income of charitable organizations is exempt from taxation, and, second, that the income received by estates and trusts is given "conduit" treatment, in the sense that such income is treated generally as the income of the beneficiary for whose benefit it is received.[8] Thus, under the normal operation of these two principles, when an estate or trust receives income which it holds for ultimate distribution to a charitable beneficiary, such income is exempt from tax, even if not currently distributed to such charitable beneficiary.

as set forth hereinafter, this fact merely highlights the anomalous result of respondent's position, which is to deny tax exemption to such amounts when the tax is computed under § 1201(b). Congress can hardly have intended that estates and trusts having charitable beneficiaries be penalized in their utilization of § 1201(b), by comparison to the tax treatment accorded them under § 1202.

[8]Subject to certain limitations, relating to the timing of distributions, in the case of non-charitable beneficiaries.

The controversy in this case results from the fact that the respondent refuses to permit the operation of the foregoing two principles in the application of the "alternative tax" which Internal Revenue Code § 1201(b) provides with respect to long-term capital gains. As set forth above in the Statement of the Case, such tax is utilized as an alternative to the "normal" tax resulting under § 1202, when such utilization results in a lower overall tax burden. In the case of an estate or trust receiving capital gains for the benefit of a charitable beneficiary, the "normal" tax resulting under § 1202 will reflect the operation of the two principles referred to above, in that the capital gains passing to charity, even though passing through the intermediary of an estate or trust, pass free of income tax, and the tax imposed upon the estate or trust will be the same as that which would have occurred had the estate or trust never received the amounts of capital gains passing to charity.[9]

[9]The statutory mechanism through which this result is achieved is contained in § 642(c). This section, which implements the conduit principle in the case of charitable beneficiaries, essentially provides (in the form in which it existed during the years relevant to this case) for an unlimited deduction to the estate or trust for all amounts of "gross income . . . paid or permanently set aside for" charitable purposes. (Since long-term capital gains so "paid or permanently set aside" also qualify for the 50% capital gains deduction provided by § 1202, § 642(c) contains a provision requiring that "proper adjustment of the deduction otherwise allowable under this subsection shall be made for any deduction allowable to the estate or trust under section 1202." This adjustment is necessary in order to achieve a deduction which precisely equals, but does not exceed, the amount of capital gains which the estate or trust receives for its charitable beneficiaries.) Although § 642(c) speaks in terms of a "deduction", the effect of the section is to exclude from the taxable income of an estate or trust, as though never received by that entity, all amounts of gross income, including long-term capital gains, which are ultimately payable to charitable beneficiaries.

In spite of the fact that the application of the "normal" tax, in the case of an estate or trust receiving capital gains destined for charities, thus reflects the perfect operation of the conduit principle,[10] the respondent nevertheless contends that the application of the "alternative tax" in such cases should disregard the conduit theory and, in a case such as this one, result in a tax burden greater than that which would occur had the capital gains been received directly by the charitable beneficiaries.

As support for its position, the respondent relies upon a mechanical interpretation of § 1201(b), specifically subparagraph (b)(2) thereof, which provides, in addition to a "partial tax" computed under subparagraph (b)(1),[11] a tax "equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss." Since the statutory language of subparagraph (b)(2) does not expressly contain any further characterization of the "excess" to which the 25% tax is to be applied, the respondent contends that such "excess", even in the case of an estate or

[10]The Ninth Circuit apparently disputes this conclusion, contending that a conduit approach to the "normal" tax computation would require that the capital gains passing to charity be deducted exclusively under § 642(c), rather than one-half under § 642(c) and one-half under § 1202. 563 F.2d 400, 404. Yet the resulting taxable income, as the Ninth Circuit's opinion makes clear, is the same in either event. (Compare the hypothetical computation of taxable income set forth at 563 F.2d 400, 402, with that set forth in fn. 6, 563 F.2d 400, 404). To contend in such circumstance that the particular mechanisms which Congress has prescribed "do not countenance a 'conduit' approach in calculating the normal tax" (563 F.2d 400, 405) is an exaltation not merely of form, but rather of the petty refinements of form, over the substance which emerges clearly from the statutory provisions.

[11]The "partial tax" under § 1201(b)(1) is designed to equal that amount of tax which would be imposed in the absence of net long-term capital gain.

trust having charitable beneficiaries, must include all of the net long-term capital gain received by the estate or trust, even that portion thereof which is owned by, and which the estate or trust is required to pass on to, its charitable beneficiaries.

The respondent defends this mechanical interpretation of § 1201(b) by contending that the conduit principle applies only to the non-charitable beneficiaries of an estate or trust and that the principle has no application in the case of charitable beneficiaries.

The respondent's error lies both in its needlessly restrictive approach to the language of § 1201(b) and in its failure to recognize the conduit principle's applicability to charitable beneficiaries of estates and trusts. As set forth more fully below, the applicability of the conduit principle to charitable beneficiaries is apparent not only from the statutory provisions of the Internal Revenue Code itself, but also from the long-standing judicial recognition of that applicability. Furthermore, nothing in the language of § 1201(b) prevents the operation of the conduit principle in the application of the alternative tax. To the contrary, there exists ample authority, discussed below, for a construction of § 1201(b) which permits deductions or exclusions from the amount of net long-term capital gain to which the alternative tax is applied. Additionally, the respondent's error is further evidenced by the absurd tax consequences in which the respondent's position herein will sometimes result.

ARGUMENT.

I

The Conduit Principle Underlying the Taxation of Estates and Trusts Is Applicable With Respect to Charitable Beneficiaries of Estates and Trusts.

The respondent's position in this case, and the Ninth Circuit's acceptance of that position, stem from their failure to recognize that the conduit principle applies not only with respect to non-charitable beneficiaries but also with respect to charitable beneficiaries of estates and trusts. When Congress enacted the Internal Revenue Code of 1954, it specifically confirmed the conduit principle's applicability to estates and trusts, without indicating any legislative intent that said principle should be less applicable to charitable beneficiaries than to non-charitable beneficiaries thereof. As set forth in the House Committee Report on the Internal Revenue Code of 1954, in its discussion of the general rules for the taxation of estates, trusts and their beneficiaries (as contained in §§ 641-643, which sections include § 642(c)), the House Ways and Means Committee observed that:

> "The bill adheres to the conduit theory of the existing law. This means that an estate or trust is in general treated as a conduit through which income passes to the beneficiary."
>
> H.R. Rep. No. 1337, 83d Cong., 2d Sess., p. 61 (3 U.S. Code Cong. & Adm. News (1954), 4017, 4087)

Based upon this legislative history, the Second Circuit Court of Appeals squarely held that the conduit principle entitles estates and trusts to treat long-term capital gains received on behalf of charitable beneficiaries as

non-taxable even when the alternative tax is employed. *Statler Trust v. C.I.R.* (2nd Cir. 1966), 361 F.2d 128, rev'g *Ellsworth M. Statler Trust* (1964), 43 Tax Ct. 208. In *Statler,* the Second Circuit determined that trustees, who were required by their governing trust instrument to distribute at least 15 percent of the trust's net income each year to various charities, were entitled to exclude the 15 percent of the trust's long-term capital gains so distributed from the amount of long-term capital gains subject to the alternative tax under Section 1201(b). In so holding, the Second Circuit emphasized the controlling nature of the conduit principle in the taxation of estates and trusts, and the legislative intent that said principle be given effect. Quoting that portion of the House Committee Report set forth above (361 F.2d 128, 131), and recognizing the applicability of the conduit principle to the amounts of capital gains at issue in the case before it, the Second Circuit in *Statler* rejected the position advocated by the respondent and sustained the position of the petitioners herein.

Subsequent to the Second Circuit's decision in *Statler,* Congress has twice amended both § 1201(b) and § 642(c), in each case without changing either section in any respect relevant to the question herein. (See, P.L. 94-455, § 1901(a) (135)(C) and § 1901(b) (33), and P.L. 91-172, § 511(b), amending § 1201 (b); P.L. 94-455, §§ 1402(b)(1)(J), 1402(b)(2) and 1906(b)(13)(A), and P.L. 91-172, § 201(b), amending § 642(c).) By thus in effect reenacting the statutory language construed and applied by the Second Circuit in *Statler,* Congress must be deemed to have approved and adopted the Second Circuit's decision in that case. *Shapiro v. United States* (1948),

335 U.S. 1, 16-20, 68 S.Ct. 1375, 92 L.Ed. 1787, 1798-1800; *Sherman v. Hamilton* (1st Cir. 1961), 295 F.2d 516, 520, cert. den. 369 U.S. 820, 82 S.Ct. 827, 7 L.Ed.2d 785; *Commissioner of Internal Rev. v. F. G. Bonfils Trust* (10th Cir. 1940), 115 F.2d 788, 792; *Van Vranken v. Helvering* (2nd Cir. 1940), 115 F.2d 709, 710, cert. den. 313 U.S. 585, 61 S.Ct. 1095, 85 L.Ed. 1541.

Congress' ratification of the *Statler* decision should dictate the result in this case. Indeed, to the extent that the circumstances of this case differ factually from those of *Statler,* this case presents an even stronger situation for applying the Second Circuit's reasoning. In *Statler,* the governing trust instrument gave the trustees discretion to distribute each year not less than 15 percent nor more than 30 percent of the trust's net income for the year among such charitable organizations, and in such amounts, as the trustees determined. Consequently, it could not be said in the *Statler* case that any of the charitable beneficiaries of the trust had a vested right to any amount or portion of the trust's income. In this case, however, the Disney Foundation, under the terms of Mr. Disney's will and the relevant California law, held *title* to 45 percent of the residue of Mr. Disney's estate from the time of Mr. Disney's death, and the petitioners, as co-executors of Mr. Disney's estate, merely had *possession* of the estate residue for purposes of administration. Accordingly, the petitioners in this case were, in a more literal sense than were the trustees in *Statler,* mere conduits for a charitable beneficiary.[12]

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[12]This circumstance further distinguishes the petitioners' situation from that in *Weil v. Commissioner of Internal Revenue*

(This footnote is continued on next page)

Notwithstanding the foregoing, the Ninth Circuit herein rejected the applicability of the conduit principle and sustained the respondent's position that in the application of the alternative tax such tax must be imposed even on that portion of capital gains which is owned by, and set aside for, a tax-exempt charitable beneficiary. This conclusion by the Ninth Circuit is based not only on a misconstruction of the relevant provisions of the Internal Revenue Code, but also on a disregard of the historical recognition of the conduit principle as it applies to charitable beneficiaries.

A. Applicability of the Conduit Principle to Charitable Beneficiaries of Estates and Trusts Is Apparent From the Provisions of the Internal Revenue Code.

There is no dispute in this case concerning the applicability of the conduit principle to taxable beneficiaries of estates and trusts. As the respondent recognizes,[13] the conduit principle "is the theory underlying the taxation of trusts, estates, and their beneficiaries," and is implemented, with respect to taxable beneficiaries, by §§ 661 and 662 of the Internal Revenue Code. Section 661(a) provides that the estate or trust is allowed a deduction, in computing its taxable income, equal to the sum of "any amount of income required to be distributed currently" (§ 661(a)(1)),

(6th Cir. 1956), 229 F.2d 593, in which an individual taxpayer was not permitted to deduct his charitable contributions (in excess of his ordinary income) from the amount of his capital gains in computing the alternative tax thereon. As the Second Circuit noted in *Statler*, the voluntary nature of the taxpayer's charitable contributions in *Weil* afforded the court in that case no occasion to consider the applicability and effect of the conduit principle. 361 F.2d 128, 131.

[13]Brief for the Appellant pp. 7-8, filed May 29, 1975, in the Ninth Circuit Court of Appeals.

and "any other amounts properly paid or credited or required to be distributed for such taxable year" (§ 661(a)(2)). Section 662(a) essentially requires that a beneficiary receiving an amount described in § 661(a) include such amount in his gross income. Section 663(a)(2) excludes from the operation of § 661(a) and § 662(a) such amounts as are paid to or permanently set aside for charitable beneficiaries under § 642(c).

Sections 661(a) and 662(a) thus operate as what might be termed the "taxable conduit" of the estate or trust, moving taxable income from that entity to its taxable beneficiaries, to the extent of the estate or trust's actual or required distributions to such beneficiaries. However, because amounts passing to charitable beneficiaries, deductible under § 642(c), are not included within § 661(a) and § 662(a), the respondent has contended that the provisions of the Internal Revenue Code do not reflect the operation of the conduit principle with respect to charitable beneficiaries. The decision of the Ninth Circuit herein was premised upon its acceptance of that contention, which acceptance was in turn based upon the purported ground that conduit treatment for charitable beneficiaries does not "emerge boldly from the Code's language". 563 F.2d 400, 404. In thus denying the applicability of the conduit principle to charitable beneficiaries, both the respondent and the Ninth Circuit have disregarded the fact that § 642(c) is a compelling manifestation of such applicability.

In seeking statutory support for its rejection of the conduit principle's applicability to this case, the Ninth Circuit has reasoned that if the conduit principle were applicable to charitable beneficiaries, Congress would

have provided that amounts distributed to or set aside for charities are to be "excluded" from the gross income of the estate or trust rather than simply "deducted" as § 642(c) provides. Such reasoning overlooks the fact that the income of an estate or trust which is distributed through the "taxable conduit," under § 661 and § 662, is also not excluded from the gross income of the estate or trust but is simply deducted, in that case under § 661(a). The Ninth Circuit in this case appears to have concluded that since amounts distributed to or set aside for charitable beneficiaries are not given conduit treatment identical to that given to taxable beneficiaries, such amounts are not given conduit treatment at all. Such analysis, apparently premised on the Ninth Circuit's assumption that the conduit principle can be expressed through only one statutory scheme, ignores the fact that the statutory provisions governing the taxation of estates and trusts provide very clearly, albeit separately, for the conduit treatment of amounts passing to charitable beneficiaries, creating, in effect, one system of conduit treatment for taxable beneficiaries and a separate system of conduit treatment for charitable beneficiaries.

The system of conduit treatment for charitable beneficiaries, far from being absent in the provisions of the Internal Revenue Code, is in fact a far stronger manifestation of the conduit principle than that system of conduit treatment which is provided for taxable beneficiaries. Sections 661 and 662 provide conduit treatment for taxable beneficiaries by allowing as a deduction to the estate or trust, and requiring to be taken into income by the recipient, only such amounts as are "properly paid or credited or required to be distributed" during the taxable year. Other amounts,

properly retained by the estate or trust during the taxable year, are not given conduit treatment but are instead generally taxed to the estate or trust as that entity's taxable income.[14] On the other hand, § 642(c),

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[14]The amount of taxable income which can be thus moved through the "taxable conduit" is also limited by the reference, in both §661(a) and §662(a), to "distributable net income" (or "DNI", as it is commonly abbreviated), which is defined in §643(a). The Ninth Circuit's failure to recognize the applicability of the conduit principle in this case may, in part, stem from that Court's apparent confusion concerning the operation of §643(a). The function of §643(a) is to define DNI, which, in turn, functions as the measuring device for the "taxable conduit", in that it becomes the maximum amount which may be deducted by the estate or trust under §661 and taxed to the estate or trust's taxable beneficiaries under §662. (In effect, DNI is intended to represent the amount of "taxable income" which the estate or trust has available for passage through the "taxable conduit".) The computation of DNI under §643(a) also reflects, however, a recognition of the "charitable conduit" manifested in §642(c). Since all amounts distributed to or set aside for charity pass, in effect, through the "charitable conduit" in the computation of taxable income (in that through the operation of §642(c) they are effectively excluded from taxable income), such amounts should not be included in that amount (*i.e.*, "DNI") which becomes the measuring instrument for the "taxable conduit" (under §661 and §662). Section 643(a) accomplishes this result by taking "taxable income" as the starting point for the DNI computation.

Among the several modifications of "taxable income" which §643(a) prescribes in computing DNI is the deduction, or "exclusion", from taxable income of certain capital gains, not including, however, those capital gains which have been distributed to or set aside for charity. IRC §643(a)(3). Since these capital gains have already been effectively excluded from taxable income under §642(c) (on their way through the "charitable conduit"), to exclude such amounts *again* in computing DNI would be arbitrarily to reduce the amount of "taxable income" which the estate or trust is deemed to have available for passage through the "taxable conduit." Section 643(a)(3), by denying such second exclusion, neatly accomplishes the desired result.

The Ninth Circuit, however, misconstrues the operation of §643(a)(3), and reads the denial of a second exclusion of amounts of capital gains passing to charity as meaning that such amounts "remain in distributable net income" (563 F.2d

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which implements the conduit principle in the case of charitable beneficiaries, gives the estate or trust an unlimited deduction not only for amounts which are paid for charitable purposes during the taxable year, but also for amounts which during the taxable year are "permanently set aside" for such purposes. Thus, while the conduit principle as reflected in § 661 and § 662 operates only at the time of an actual or required distribution from an estate or trust, the conduit principle as manifested in § 642(c) operates from the moment of the estate or trust's receipt of the income item in question where, as in this case, such item is required to be set aside for charitable purposes.

400, 404), and that the "specific purpose [of §643(a)(3)] is to retain capital gains so paid or set aside in distributable net income . . ." (563 F.2d 400, 406). In reaching this conclusion the Ninth Circuit overlooks the fact that the computation of DNI begins with an amount (*i.e.*, "taxable income") from which capital gains passing to charity have already been excluded and that the denial of a second exclusion for such amounts in the computation of DNI does *not* mean that such amounts are *included* in DNI, as determined under §643(a). Notwithstanding the Ninth Circuit's misreading of §643(a), that section, operating together with §642(c), quite precisely accomplishes the desired result of not including in DNI those amounts of capital gain which pass through the "charitable conduit" under §642(c).

The error of treating capital gains passing to charity as includable in DNI is apparent not only from the language and function of §643(a), but also from the fact that the inclusion of such amounts in DNI would result in a double deduction to the estate or trust, permitting such amounts to be deducted not only under §642(c), as they should be, but also under §661 to the extent that distributions to taxable beneficiaries exceed other DNI. The corollary of this excess deduction to the estate or trust would be an excess amount of taxable income deemed received by the taxable beneficiaries under §662. Although the taxable beneficiaries might then claim, with some justification, that their conduit runneth over, this excessive shifting of taxable income would, presumably, be no more in furtherance of divine providence than of Congressional intent.

B. Applicability of the Conduit Principle to Charitable Beneficiaries of Estates and Trusts Has Been Judicially Recognized.

The applicability of the conduit principle in the context of charitable beneficiaries of estates and trusts has been judicially recognized since almost the earliest enactments of the modern federal income tax law. As early as the Revenue Acts of 1916 and 1918, it was recognized that "the purpose of the statute is to exempt from taxation all income essentially belonging to religious, charitable, scientific or educational corporations," *Slocum v. Bowers* (S.D.N.Y. 1926), 15 F.2d 400, 405, aff'd, *Bowers v. Slocum* (2nd Cir. 1927), 20 F.2d 350, and that "the expressed intent of the Congress . . . was to tax the income received by the estate which would pass to any person subject to taxation, but relieve from taxation the income set aside by the terms of the will for corporations of [charitable] character. . . ." *Bowers v. Slocum* (2nd Cir. 1927), 20 F.2d 350, 352.[15] As Judge Augustus

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[15]The first modern income tax statute, the Revenue Act of 1913, contained no provision for the taxation of estates or trusts as entities, and undistributed income of estates and trusts was thereby able to escape current taxation. In the Revenue Act of 1916, Congress moved to plug this gap, by inserting a provision which taxed an estate or trust on its undistributed income. While the Revenue Act of 1916 also contained a provision exempting charitable organizations from the income tax, it did not explicitly exempt from the income tax imposed on estates and trusts that portion of undistributed income which might be allocable to charitable beneficiaries. This omission Congress corrected in the Revenue Act of 1918, by inserting a provision which allowed an estate or trust an unlimited deduction for "any part of the gross income which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid to or permanently set aside for" charitable purposes. Revenue Act of 1918, Section 219(b), 40 Stats. 1057, 1071. In *Slocum v. Bowers* (S.D.N.Y. 1926), 15 F.2d 400, aff'd, *Bowers v. Slocum* (2nd Cir. 1927), 20 F.2d 350,

(This footnote is continued on next page)

Hand observed in the district court opinion in *Slocum v. Bowers, supra,*

> "It is quite clear that the primary purpose of the amendments [contained in the Revenue Acts of 1916 and 1918] taxing estates and trusts as entities was to reach income that had not theretofore been presently taxable at all. A design to tax income where the beneficial ownership is in corporations generally exempt under the law accordingly seems contrary to the history and spirit of the statute.
>
> * * * *
>
> "I think it reasonable to suppose that the income on which income taxes must be paid by an executor while the estate is in process of administration

though the taxable year in question was covered by the Revenue Act of 1918, the government disputed the applicability of that Act's charitable deduction provision, apparently contending there that, since the decedent's will did not refer specifically to income, the income which the executors had permanently set aside for charitable purposes had not been set aside "pursuant to the terms of the will" within the language of Section 219(b) of the Revenue Act of 1918 and so did not qualify for the deduction provided by that section. Conceding the possible correctness of this interpretation of Section 219(b), District Judge Augustus Hand concluded that the income in question was exempt from tax regardless of the applicability or non-applicability of that particular section. As set forth in the text, *infra,* Judge Hand cited the limited purpose of the 1916 Act in first imposing the income tax on estates and trusts, the general exemption from income tax for charities contained both in the 1916 Act and in Section 231(6) of the 1918 Act, and the consequent inapplicability of the income tax to the income in question in the *Slocum* case, irrespective of whether such income was accorded an express statutory deduction. (While the Second Circuit in the *Slocum* case affirmed Judge Hand's decison on somewhat narrower grounds, that Court, as did Judge Hand, emphasized the Congressional intent to impose the tax only on such income in the possession of an estate or trust as would be subject to the tax but for the interposition of the estate or trust. See text, *supra,* immediately preceding this footnote.)

> or settlement is only such income as is ultimately taxable as such and that the liability of income to taxation does not depend on where the legal title is vested but upon who is ultimately entitled to the property constituting that income."
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> *Slocum v. Bowers,* 15 F.2d 400, 403-404

The congressional intention to exempt from taxation "all income essentially belonging to" charitable organizations requires that such amounts not be subjected to tax simply because of an executor's failure to distribute such amounts to the charitable organization. This was expressly recognized by both the district and the circuit courts in the *Bowers v. Slocum* decisions. *Slocum v. Bowers, supra,* 15 F.2d 400, 405; *Bowers v. Slocum, supra,* 20 F.2d 350, 352. As the Circuit Court observed, in *Bowers v. Slocum,*

> "[To] make the imposition of the tax depend upon some act of the executors, which had no result in law upon the rights of the parties, . . . is not in accordance with what we have found to be the expressed intent of the Congress, which was to tax the income received by the estate which would pass to any person subject to taxation, but relieve from taxation the income set aside by the terms of the will for corporations of the character described."
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> *Bowers v. Slocum,* 20 F.2d 350, 352

In spite of this clear judicial recognition of a Congressional intent, in providing for the taxation of estates with charitable beneficiaries, not to permit the imposition of the tax to turn upon a discretionary act or

omission of an estate's executors, such imposition of the tax is the inevitable consequence of the Ninth Circuit's decision in this case. If the petitioners, instead of selling the residuary securities allocable to the Disney Foundation, had, pursuant to California Probate Code, § 1000, made a partial distribution of those securities to the Foundation, there can be no question but that any gains realized by the Disney Foundation on its own subsequent sale of those securities would have been wholly exempt from tax, while at the same time the gains realized on the remaining 55 percent of the residuary securities would have been eligible for the alternative tax provided by Section 1201(b). The position of the respondent, and the Ninth Circuit's decision in this case, cause the amount of the tax to depend squarely upon whether the representative of the estate has exercised his discretion to seek a partial distribution of the estate, a result clearly at variance, not only with logic, but also with long recognized and clearly expressed Congressional intent.

II

Deductions From Long-Term Capital Gains Before Application of the Alternative Tax Are Permitted in Furtherance of Congressional Intent.

Compounding its rejection in this case of the conduit principle's applicability to charitable beneficiaries, the Ninth Circuit has purported instead to "interpret section 1201(b) . . . precisely as it is written," 563 F.2d 400, 405. Based upon its observation that the language of § 1201(b) does not expressly provide for any deductions from the amount of net long-term capital gain to which the alternative tax is applied, the Ninth Circuit has concluded that

> "[T]he excess of the net long-term capital gain over the net short-term capital loss for the purpose of this section is *required* to be computed without reduction for any amount distributed to or set aside for charity." [Emphasis added]
>
> 563 F.2d 400, 405

The Ninth Circuit's reading of § 1201(b), resulting in the supposed "requirement" set forth above, is not "precise" but merely procrustean. While the language of § 1201(b) does not expressly mandate a "reduction for . . . amount[s] distributed to or set aside for charity", the statute also does not, either expressly or by implication, prohibit such reduction; nor does the statute require that it be construed in derogation of other pertinent provisions of the Internal Revenue Code, such as § 642(c). The Ninth Circuit's total disregard of the significance of § 642(c), and of the conduit principle which (as discussed *supra*) is manifested therein, is an egregious violation of the pertinent rule of statutory construction recently reiterated by this Court in *Kokoszka v. Belford* (1974), 417 U.S. 642, 650, 94 S.Ct. 2431, 41 L.Ed.2d 374, 381:

> "When 'interpreting a statute, the court will not look merely to a particular clause in which general words may be used, but will take in connection with it the whole statute (or statutes on the same subject) and the objects and policy of the law, as indicated by its various provisions, and give to it such a construction as will carry into execution the will of the Legislature. . . .' Brown v Duchesne, 19 How 183, 194, 15 L Ed 595 (1857)."
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> *Kokoszka v. Belford*, 417 U.S. 642, 650, 94 S.Ct. 2431, 41 L.Ed.2d 374, 381

Similarly, as this Court noted in *Philbrook v. Glodgett* (1975), 421 U.S. 707, 713-714, 95 S.Ct. 1893, 44 L.Ed.2d 525, 532-533:

> " 'In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy.' United States v Heirs of Boisdoré, 8 How 113, 122, 12 L Ed 1009 (1849). Richards v United States, 369 US 1, 11, 7 L Ed 2d 492, 83 S Ct. 585 (1962); Chemehuevi Tribe of Indians v FPC, 420 US 395, 402-403, 43 L Ed 2d 279, 95 S Ct 1066 (1975). Our objective in a case such as this is to ascertain the congressional intent and give effect to the legislative will . . ."
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> *Philbrook v. Glodgett*, 421 U.S. 707, 713, 95 S.Ct. 1893, 44 L.Ed.2d 525, 532-533

The Ninth Circuit's supposedly "precise" interpretation of § 1201(b), based upon its efforts to construe that section's language in a vacuum and in total disregard of the statutory context, plainly fails to give effect to the Congressional will which is manifested therein. Furthermore, such interpretation not only disregards the long established and clearly expressed Congressional policy that conduit treatment is to be accorded amounts passing to charitable beneficiaries of estates and trusts; it also ignores the fact that the supposedly "precise" language of § 1201(b) is "flexible" enough to permit, in appropriate situations, a deduction from the amount of capital gains to which the alternative tax is applied. The cases of *Meissner*

v. United States (Ct. Cl. 1966), 364 F.2d 409; *Read v. United States* (5th Cir. 1963), 320 F.2d 550; and *Estate of Harry B. Sidles* (1976), 65 Tax Ct. 873, demonstrate unequivocally that § 1201(b) permits a deduction from the amount of capital gains to which the alternative tax is applied, despite the absence of an express provision therefor, when the effect of permitting such deduction is in furtherance of Congressional intent.

In *Read v. United States* (5th Cir. 1963), 320 F.2d 550 and in *Meissner v. United States* (Ct. Cl. 1966), 364 F.2d 409, the Fifth Circuit Court of Appeals and the Court of Claims, respectively, held that the income tax deduction permitted by Internal Revenue Code Section 691(c), for the amount of estate tax allocable to income in respect of a decedent, could be used as a deduction from the estate's capital gains before application of the alternative tax. While acknowledging the absence of any express provision for such deduction in Section 1201(b), both Courts found the allowance of the deduction necessary in order to fulfill the Congressional purpose behind the Section 691(c) deduction, *i.e.*, the avoidance of imposition of both estate and income taxes on the amount included in an estate as income in respect of a decedent.[16]

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[16]Congress' reenactment of §1201(b), as set forth above (p. 12), and of §691(c) (See, P.L. 94-455, §§1901(a)(91), 2005(a)(4), and 2006(b)(3)), without amending either section in any respect relevant to the issue herein (or to the issue in the above cases) is further indicative of Congress' adoption of the petitioners' construction of §1201(b).

In the more recent case of *Estate of Harry B. Sidles* (1976), 65 Tax Ct. 873, the respondent effectively acquiesced in this "flexible" interpretation of § 1201(b), contending in *Sidles* that, where the income in respect of a decedent consists solely of long-term capital gains and the estate utilizes the alternative tax, the deduction provided by § 691(c) should be available *only* as a deduction from the capital gains to which the alternative tax is applied rather than being available also as a deduction from ordinary income.[17]

Although the *Read, Meissner* and *Sidles* cases were concerned primarily with a provision of the Internal Revenue Code not directly related to the conduit treatment of estates and trusts having charitable beneficiaries, that circumstance does not, contrary to the Ninth Circuit's conclusion herein, make those cases "inapposite to the issue before us". 563 F.2d 400, 405. The significance of those cases is that, notwithstanding the supposedly "precise" language of § 1201(b), deductions will be permitted thereunder where such deductions have the effect of implementing a Congressional policy reflected in other provisions of the Internal Revenue Code. The policy underlying § 691(c), which the courts in *Read* and *Meissner* (and the respondent in *Sidles*) recognized as sufficient to permit a deduction from capital gains under § 1201(b)(2), was:

> "[T]o provide approximately the same tax consequences in the case of a decedent whose gross

[17]The Tax Court rejected the respondent's argument in *Sidles*, holding instead that the estate could apply the § 691(c) deduction in whatever manner was most advantageous to it, which in that case meant using the deduction first against ordinary income, and then applying the excess against long-term capital gains before application of the alternative tax.

> estate includes claims to income as in the case of a decedent all of whose income receivables had been collected (and income tax paid thereon) prior to his death. * * * [2 Mertens, Law of Federal Income Taxation, sec. 12.102(b), ch. 12, p. 404.]"
>
> Quoted in *Estate of Harry B. Sidles*, 65 Tax Ct. 873, 886

At issue in the instant case is the Congressional policy to provide the same tax consequences in the case of an estate or trust receiving amounts of income for a charitable beneficiary as in the case of a charitable beneficiary receiving such amounts directly, without the interposition of the fiduciary entity (such tax consequences being, of course, the complete exemption of such amounts from tax). This policy, so long recognized as a fundamental purpose of the federal income taxation of estates and trusts having charitable beneficiaries,[18] should be at least as compelling in the instant case with respect to the interpretation of § 1201(b), as was the policy behind § 691(c) in the cases of *Read, Meissner* and *Sidles*.

Also illustrative of the philosophy of statutory construction appropriate to this case is *United States v. Pleasants* (1939), 305 U.S. 357, 59 S.Ct. 281, 83 L.Ed. 217. That case, while involving neither the conduit principle nor the construction of the alternative tax, did involve a conjunction of those special statutory tax provisions pertaining to charities with those pertaining to capital gains and losses. Under the revenue laws in effect at the time of the *Pleasants* case, an individual was permitted to deduct from his taxable

[18]See, *e.g., Slocum v. Bowers, supra,* 15 F.2d 400, 405.

income the amount of his charitable contributions, but only to the extent of "15 per centum of the taxpayer's net income . . .", and the issue in the *Pleasants* case was the proper measure of "net income", for purposes of that limitation, in a situation in which the taxpayer not only had made significant charitable contributions but also had incurred significant "capital net losses".[19] As against the government's argument that the statutory definition of "net income" on its face required capital losses to be deducted in computing "net income", the Supreme Court held that, based upon the special statutory provisions both for charities and for capital gains and losses, the term "net income", when used as the limiting measure of a taxpayer's deduction for charitable contributions, should be construed as "the taxpayer's net income which under the statutory scheme is actually subject to tax" (305 U.S. 357, 362, 83 L.Ed. 217, 220-221) prior to the "alternative" deduction for "capital net losses". Referring to its earlier opinion in *Helvering v. Bliss* (1934), 293 U.S. 144, 55 S.Ct. 17, 79 L.Ed. 246, the Supreme Court noted that:

> "We observed in the Bliss Case that the exemption of income devoted to charity and the reduction of the rate of tax on capital gains 'were liberalizations of the law in the taxpayer's favor, were begotten from motives of public policy, and are not to be narrowly construed.' That observation is equally pertinent here."
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> *United States v. Pleasants,* 305 U.S. 357, 363, 59 S.Ct. 281, 83 L.Ed. 217, 221

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[19]Such losses were at that time subject to what amounted, in effect, to a mandatory "alternative" deduction, limiting the deductibility of "capital net losses" to a flat rate of 12½%.

The foregoing observation is equally pertinent to the instant case. Both "liberalizations of the law" referred to in the *Pleasants* case are at issue herein, and unless the Supreme Court is abruptly to reverse its prescription in that case that these liberalizations "are not to be narrowly construed", the position of the petitioners in this case must be sustained.

III

The Respondent's Interpretation of the Alternative Tax Will Have Absurd Tax Consequences.

The imposition of the higher income tax which results in this case from the respondent's mechanical interpretation of § 1201(b) operates as a penalty on the estate's possession of capital assets sold for the accounts of both charitable and non-charitable beneficiaries. This penalty, so clearly at variance with Congressional intent regarding the taxation of charities, serves to underscore the applicability of the conduit principle to the facts of this case. Equally indicative, however, of the conduit principle's general applicability to the taxation of capital gains received by an estate or trust for a charitable beneficiary, is the fact that in other situations, similar to the instant one but involving a slightly different combination of capital gains and ordinary income, the respondent's approach will result, not in an unintended penalty, as here, but rather in an equally unintended windfall for the taxpayer (coupled with an unintended, corresponding loss to the public revenues).

As discussed above, the respondent's position herein is premised on its reading of § 1201(b), specifically that portion of § 1201(b)(2) which refers to the "excess of the net long-term capital gain over the

net short-term capital loss."[20] Construing that "excess" (*i.e.*, the amount which is subject to the 25 percent tax under § 1201(b)(2)) as permitting no exclusion or deduction for amounts passing through an estate or trust to charity, the respondent, as consistency requires, construes the term "such excess" appearing in § 1201(b)(1) to mean the same thing.[21] Yet the "excess" referred to in subparagraph (b)(1), although the same "excess" as that referred to in subparagraph (b)(2), is the measure not of a tax but of a deduction, *i.e.*, that deduction, "equal to 50 percent of such excess", which is taken from taxable income in computing the "partial tax" under § 1201(b)(1). Since the computation of the "taxable income" from which this deduction is taken has already included a deduction equal to *100 percent* of the capital gains passing to charity

[20]As is described briefly above, the alternative tax under § 1201(b) is the sum of two distinct and separately computed taxes, one being the "partial tax" computed under § 1201(b)(1) and the other being the 25% capital gains tax computed under § 1201(b)(2). The object of the partial tax is to equal that amount of tax which would be imposed on the taxpayer's ordinary net income (*i.e.*, the amount of tax which would be imposed on the taxpayer's net income exclusive of net long-term capital gain), and the statute arrives at this result by computing the partial tax on an amount equal to "the taxable income reduced by an amount equal to 50 percent of [the] excess" of "the net long-term capital gain" over "the net short-term capital loss". Since the computation of the taxpayer's taxable income has already included a deduction, under § 1202, of 50% of the "excess" just referred to, the deduction of another 50% under § 1201(b)(1) results in an amount subject to the partial tax which should precisely equal the taxpayer's ordinary net income. Once the partial tax has been thus computed, the total alternative tax is then derived by adding to the "partial tax" the capital gains tax, computed under § 1202(b)(2), in "an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss."

[21]See, e.g., the hypothetical alternative tax computation under the respondent's approach, described in the Ninth Circuit's opinion herein, 563 F.2d 400, at 402-403.

(i.e., 50 percent under § 1202 and the remaining 50 percent under § 642(c)), the effect of the respondent's approach is to provide a cumulative deduction equal to 150 percent of such capital gains in computing the "partial tax" under § 1201(b)(1).[22]

This multiple deduction, while flowing inevitably from the respondent's mechanical approach to § 1201(b), can hardly have been countenanced by Congress as a part of its scheme for the taxation of charities and estates and trusts. The function of the "partial tax" computation under § 1201(b) is to determine the amount of tax which would be payable on ordinary net income alone, in the absence of net long-term capital gain.[23] Consequently, the allowance, in such computation, of a cumulative deduction *greater* than the amounts of such gain received by the estate or trust for its charitable beneficiaries is inconsistent with that purpose, resulting in a lower "partial tax" than was intended and creating a "partial" windfall to the estate or trust as a result of that entity's receiving amounts destined for charity.

Furthermore, the respondent's position herein is inconsistent not only on a conceptual level with the purpose of the alternative tax computations. In its practical effect, the multiple deduction which results, under § 1201(b)(1), from the respondent's position may in some cases more than offset the additional tax which results, under § 1201(b)(2), from the re-

[22]See the hypothetical computation referred to in footnote 21, *supra.*

[23]As described in footnote 20, *supra,* the total "alternative tax" is then determined by the addition to the partial tax of the flat 25% tax imposed with respect to net long-term capital gain under § 1201(b)(2).

spondent's interpretation of that subparagraph, thereby creating an overall windfall to the estate or trust in the form of a total alternative tax lower than that which would have resulted had the charitable and non-charitable interests been contained in separate taxable entities rather than combined in one.

Although the respondent's rejection of the conduit principle in its construction of § 1201(b) has resulted, in the instant case, in a higher alternative tax than did the petitioners' adherence to the conduit principle, the potential for the opposite result can be easily demonstrated by a simple hypothetical.[24] If, for example, one were to assume that the effective tax rate on ordinary net income was 60% and that the estate's receipts consisted of $125,000 in ordinary income and $500,000 in long-term capital gains, with one-half

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[24]In the instant case the respondent's approach resulted in a higher alternative tax than did the petitioners' due to the fact that the ordinary income received by the estate was inadequate to absorb fully the respondent's multiple deduction under § 1201(b)(1), thereby resulting in a partial "wastage" of that multiple deduction. This can be seen from the hypothetical which was used by the Ninth Circuit in its opinion below. 563 F.2d 400, 402. (Said hypothetical is based on rounded figures roughly approximating the estate's receipts during 1967 and is a slight variation of the hypothetical set forth, herein, in the text.)

In its opinion, the Ninth Circuit characterizes the petitioners as being "troubled" by this "wastage" and as utilizing the conduit approach to §1201(b) for the purpose of "eliminating the 'wastage'". 563 F.2d 400, 403. This characterization is incorrect. The real "wastage" which the conduit approach is intended to avoid is not the loss of an excessive and unintended multiple deduction resulting from the respondent's mechanical construction of the "partial tax" under §1201(b)(1), but rather the loss of the charitable exemption which results from the respondent's mechanical construction of the capital gains tax under §1201(b)(2).

of the capital gains being allocable to a charitable beneficiary, then the petitioners' and the respondent's respective determinations of the normal tax and the alternative tax would be the following:

With respect to the normal tax, both the petitioners and the respondent would compute the estate's taxable income as being $250,000, resulting in a normal tax of $150,000, as follows:

Gross Income		$625,000
Less: Sec. 1202 deduction	$250,000	
Sec. 642(c) deduction	125,000	
Total Deductions	$375,000	
Estate Taxable Income		$250,000
		x 60%
Normal Tax		$150,000

The petitioners, following the conduit approach, would determine the alternative tax to be $137,500, as follows:

Estate taxable income	$250,000
Less: 50% of that portion of the excess of net long-term capital gain over net short-term capital loss not permanently set aside for charity. (50% of $250,000)	$125,000
Partial Taxable Income	$125,000
Partial Tax (assuming 60% effective rate)	$ 75,000
Tax on Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss Not Permanently Set Aside for Charity (25% of $250,000)	$ 62,500
Total Alternative Tax	$137,500

The respondent, following the mechanical approach for which it contends herein, would determine the alternative tax to be $125,000, as follows:

Estate Taxable Income	$250,000
Less: 50% of all the excess of net long-term capital gain over net short-term capital loss (50% of $500,000)	$250,000
Partial Taxable Income	0
Partial Tax (assuming 60% effective rate)	0
Tax on Excess of All Net Long-Term Capital Gain Over Net Short-Term Capital Loss (25% of $500,000)	$125,000
Total Alternative Tax	$125,000

Thus, in the foregoing hypothetical, both the petitioners' approach and the respondent's approach result in an alternative tax which is less than the normal tax, and, hence, each approach will result in the use of the alternative tax. However, the respondent's approach results in a lower alternative tax, due to the fact that the ordinary income is sufficient in the hypothetical to take full advantage of the multiple deduction which the respondent's approach creates for capital gains passing to charity. The petitioners' computation of the alternative tax, as does the agreed upon computation of the normal tax, results in a total tax equal in amount to that which would result had the amounts passing to charity never been held by the estate or trust and had the estate or trust instead been limited to interests of a non-charitable, taxable nature.[25] The

[25]Thus, in the absence of the capital gains passing to charity, the estate's receipts would consist of $250,000 in capital gains and $125,000 in ordinary income, and the normal tax and alternative tax would be computed as follows:

respondent's approach, on the other hand, through the multiple deduction which is the inevitable corollary of its mechanical interpretation of § 1201(b), results in a tax lower than that which would result in such case, creating a windfall for the taxpayer by virtue of the combination of both charitable and non-charitable interests in one estate or trust. It is inconceivable that Congress could have intended either this windfall, which results from such combination in the hypothetical, or the penalty which results from such combination (under the respondent's approach) in the instant case. Regardless of which side it may happen to favor in a particular case, the respondent's interpretation of § 1201(b) does clear violence to the Congressional intent "that an estate or trust [be] treated as a conduit through which income passes to the beneficiary." H.R. Rep. No. 1337, 83rd Cong., 2d Sess., p. 61 (3 U.S.

Normal Tax	
Gross Income	$375,000
Less: Sec. 1202 deduction	125,000
Estate Taxable Income	$250,000
	x 60%
Normal Tax	$150,000
Alternative Tax	
Estate taxable Income	$250,000
Less: 50% of the excess of net long-term capital gain over net short-term capital loss (50% of $250,000)	$125,000
Partial taxable income	$125,000
Partial tax (assuming 60% effective rate)	$ 75,000
Tax on Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss (25% of $250,000)	$ 62,500
Total Alternative Tax	$137,500

As can be seen by comparison to the hypothetical example in the text, the foregoing amounts of normal tax and alternative tax are precisely the same as those which would result from the petitioners' application of the conduit principle.

Code Cong. & Adm. News (1954) 4017, 4087). The capricious nature of the divergencies from the Congressionally intended result which occur under the respondent's approach serves only further to heighten the incongruous and unreasonable nature of the respondent's construction of § 1201(b).[26]

Conclusion.

Few Congressional policies are more clearly evidenced in the Internal Revenue Code than the policy to exempt from taxation amounts passing to charitable organizations. As Judge Augustus Hand observed, in his district court opinion in *Slocum v. Bowers, supra,*

> "[I] believe that broadly speaking the purpose of the statute is to exempt from taxation all income essentially belonging to religious, charitable, scientific or educational corporations."
>
> *Slocum v. Bowers,* 15 F.2d 400, 405

[26]The Respondent will no doubt contend herein, as it did below, that its construction of § 1201(b) adheres more than does the petitioners' construction to the literal meaning of the statutory language. Even if one were to accept that contention, which the petitioners do not (since, as set forth above, the language of § 1201 (b) is equally consistent with the petitioners' construction thereof), the absurd consequences of the respondent's "literal" construction would, alone, require its rejection. "A literal application of a statute which would lead to absurd consequences is to be avoided whenever a reasonable application can be given which is consistent with the legislative purpose. [Citations omitted]" *United States v. Ryan* (1931), 284 U.S. 167, 175, 52 S.Ct. 65, 76 L.Ed. 224, 229.

In a similar vein, this Court has more recently renewed its observation that " '[i]t is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers.' Church of the Holy Trinity v United States, 143 US 457, 459, 36 LEd 226, 12 SCt 511 (1892)." *Philbrook v. Glodgett* (1975), 421 U.S. 707, 714, 95 S.Ct. 1893, 44 L.Ed.2d 525, 533.

It has long been recognized that both the statutory provisions granting favored tax treatment to charities, and those granting such treatment to long-term capital gains, "were begotten from motives of public policy, and are not to be narrowly construed." *United States v. Pleasants* (1939), 305 U.S. 357, 363, 59 S.Ct. 281, 83 L.Ed. 217, 221, *supra,* quoting from *Helvering v. Bliss* (1934), 293 U.S. 144, 151, 55 S.Ct. 17, 20, 79 L.Ed. 246, 251. The respondent's position in this case violates the foregoing precept in both respects. The interpretation of § 1201(b) for which the respondent herein contends is not only an unduly narrow construction of the statutory provisions favoring long-term capital gains. It is, perhaps more significantly, by its necessary effect, an unduly narrow construction of the policy of charitable exemption which underlies the Internal Revenue Code. Regardless of whether the taxable beneficiaries or the charitable beneficiaries of the estate in this case were to bear the additional tax which results from the respondent's position, the inevitable consequence of such tax would be to increase the cost of, and hence to discourage, individual contributions to charity. Such consequence, so manifestly inconsistent with the strong Congressional tax policy favoring charities, can be easily avoided by a reasonable construction of the statutory provisions pertinent to this case.

For all of the reasons stated herein, the petitioners respectfully request that the decision by the Ninth Circuit Court of Appeals herein be reversed.

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APPENDIX OF STATUTES INVOLVED.

26 U.S.C. § 501.

(a) EXEMPTION FROM TAXATION.—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502, 503, or 504.

(c) LIST OF EXEMPT ORGANIZATIONS.—The following organizations are referred to in subsection (a):

* * *

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office. (All statutory provisions set forth herein appear in the respective versions of such provisions which were in effect during the taxable years in question.)

26 U.S.C. § 642.

* * *

(c) DEDUCTION FOR AMOUNTS PAID OR PERMANENTLY SET ASIDE FOR A CHARITABLE PURPOSE.—In the case of an estate or trust (other than a trust meeting the specifications of subpart B) there shall be allowed as a

deduction in computing its taxable income (in lieu of the deductions allowed by section 170(a), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid or permanently set aside for a purpose specified in section 170(c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit. For this purpose, to the extent that such amount consists of gain from the sale or exchange of capital assets held for more than 6 months, proper adjustment of the deduction otherwise allowable under this subsection shall be made for any deduction allowable to the estate or trust under section 1202 (relating to deduction for excess of capital gains over capital losses). In the case of a trust, the deduction allowed by this subsection shall be subject to section 681 (relating to unrelated business income and prohibited transactions).

26 U.S.C. § 643.

(a) DISTRIBUTABLE NET INCOME.—For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—

(1) DEDUCTION FOR DISTRIBUTIONS.—No deduction shall be taken under sections 651 and 661 (relating to additional deductions).

(2) DEDUCTION FOR PERSONAL EXEMPTION.—No deduction shall be taken under

section 642(b) (relating to deduction for personal exemptions).

(3) CAPITAL GAINS AND LOSSES.—Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account.

(4) EXTRAORDINARY DIVIDENDS AND TAXABLE STOCK DIVIDENDS.—For purposes only of subpart B (relating to trusts which distribute current income only), there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.

(5) TAX-EXEMPT INTEREST.—There shall be included any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements

allocable to such interest but for the provisions of section 265 (relating to disallowance of certain deductions).

(6) INCOME OF FOREIGN TRUST.—In the case of a foreign trust—

(A) There shall be included the amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of section 265(1) (relating to disallowance of certain deductions).

(B) Gross income from sources within the United States shall be determined without regard to section 894 (relating to income exempt under treaty).

(C) Paragraph (3) shall not apply to a foreign trust created by a United States person. In the case of such a trust, (i) there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges, and (ii) the deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account.

(7) DIVIDENDS.—There shall be included the amount of any dividends excluded from gross income pursuant to section 116 (relating to partial exclusion of dividends received).

If the estate or trust is allowed a deduction under section 642(c), the amount of the modifications specified in paragraphs (5) and (6) shall be reduced to the extent that the amount of income which is paid, permanently set aside, or to be used for the purposes specified in section 642(c) is deemed to consist of items specified in those paragraphs. For this purpose, such amount shall (in the absence of specific provisions in the governing instrument) be deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes.

26 U.S.C. § 661.

(a) DEDUCTION.—In any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of—

(1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and

(2) any other amounts properly paid or credited or required to be distributed for such taxable year;

but such deduction shall not exceed the distributable net income of the estate or trust.

26 U.S.C. § 662.

(a) INCLUSION—Subject to subsection (b), there shall be included in the gross income of a beneficiary to whom an amount specified in section 661 (a) is paid, credited, or required to be distributed (by an

estate or trust described in section 661), the sum of the following amounts:

(1) AMOUNTS REQUIRED TO BE DISTRIBUTED CURRENTLY.—The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not. If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (computed without the deduction allowed by section 642 (c), relating to deduction for charitable, etc. purposes) of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to such beneficiary bears to the amount required to be distributed currently to all beneficiaries. For purposes of this section, the phrase "the amount of income for the taxable year required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent such amount is paid out of income for such taxable year.

(2) OTHER AMOUNTS DISTRIBUTED.—All other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year. If the sum of—

(A) the amount of income for the taxable year required to be distributed currently to all beneficiaries, and

(B) all other amounts properly paid, credited, or required to be distributed to all beneficiaries

exceeds the distributable net income of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (reduced by the amounts specified in (A)) as the other amounts properly paid, credited or required to be distributed to the beneficiary bear to the other amounts properly paid, credited, or required to be distributed to all beneficiaries.

26 U.S.C. § 691.

* * *

(c) DEDUCTION FOR ESTATE TAX.—

(1) ALLOWANCE OF DEDUCTION.—

(A) GENERAL RULE.—A person who includes an amount in gross income under subsection (a) shall be allowed, for the same taxable year, as a deduction an amount which bears the same ratio to the estate tax attributable to the net value for estate tax purposes of all the items described in subsection (a) (1) as the value for estate tax purposes of the items of gross income or portions thereof in respect of which such person included the amount in gross income (or the amount included in gross income, whichever is lower) bears to the value for estate tax purposes of all the items described in subsection (a)(1).

(B) ESTATES AND TRUSTS.—In the case of an estate or trust, the amount allowed as a deduction under subparagraph (A) shall be computed by excluding from the gross income of the estate or trust the portion (if any) of the items described in subsection (a)(1) which is properly paid, cred-

ited, or to be distributed to the beneficiaries during the taxable year. This subparagraph shall apply to the same taxable years, and to the same extent, as is provided in section 683.

(2) METHOD OF COMPUTING DEDUCTION.—For purposes of paragraph (1)—

(A) The term "estate tax" means the tax imposed on the estate of the decedent or any prior decedent under section 2001 or 2101, reduced by the credits against such tax.

(B) The net value for estate tax purposes of all the items described in subsection (a)(1) shall be the excess of the value for estate tax purposes of all the items described in subsection (a)(1) over the deductions from the gross estate in respect of claims which represent the deductions and credit described in subsection (b). Such net value shall be determined with respect to the provisions of section 421(c)(2), relating to the deduction for estate tax with respect to stock options to which part II subchapter D applies.

(C) The estate tax attributable to such net value shall be an amount equal to the excess of the estate tax over the estate tax computed without including in the gross estate such net value.

26 U.S.C. § 1201.

* * *

(b) OTHER TAXPAYERS.—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is

less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

26 U.S.C. § 1202.

In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains for the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

California Probate Code, § 300.

Estates All Subject to Court Administration—Exceptions

When a person dies, the title to his property, real and personal, passes to the person to whom it is devised or bequeathed by his last will, or, in the absence of such disposition, to the persons who succeed to his estate as provided in Division II of this code; but all of his property shall be subject to the possession

of the executor or administrator and to the control of the superior court for the purposes of administration, sale or other disposition under the provisions of Division III of this code, and shall be chargeable with the expenses of administering his estate, and the payment of his debts and the allowance to the family, except as otherwise provided in this code.

California Probate Code, § 1000.

Petition for Distribution, Preliminary—2 Months After Notice

When two months have elapsed after the first publication of notice to creditors and upon bond—or with or without bond, as the court determines, when the time for filing or presenting claims has expired and all uncontested claims have been paid or are sufficiently secured by mortgage, or otherwise, but the estate is not in a condition to be finally closed and distributed—the executor or administrator, or any heir, devisee or legatee, or the assignee, grantee or successor in interest of any heir, devisee, or legatee, may petition the court for distribution of a legacy, devise or share of the estate or any portion or portions thereof to which he is entitled or a payment on account of the legacies to the heirs, devisees or legatees or any assignees, grantees, or successors in interest or where there are priorities, to those of the class or classes having priorities; or, if the decedent was a nonresident and left a will which has been duly proved or allowed in the state of his residence, and such will has been admitted to probate in this state pursuant to Article 4 (commencing with Section 360) of Chapter 1 of Division 3 of this code, or if he died intestate, and

an administrator has been duly appointed and qualified in the state of his residence, and it is necessary, in order that the estate or any part thereof may be distributed according to the will, or it is for the best interests of the estate, that any part of the estate in this state should be delivered to the executor or administrator in the state of the decedent's residence, the executor or administrator may petition the court for an order authorizing the delivery of such portion of the estate as the court shall deem safe and proper and for the best interests of the estate, to the executor or administrator in the state of decedent's residence.

The clerk shall set the petition for hearing by the court and give notice thereof for the period and in the manner required by Section 1200 of this code. Any person interested in the estate or any coexecutor or coadministrator may resist the application.

Service of the within and receipt of a copy thereof is hereby admitted this ..... day of May, A.D. 1978.

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